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Commonwealth Securities Limited: The Leading Australian Online, Discount Stockbroker

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COMMONWEALTH SECURITIES LIMITED: THE LEADING AUSTRALIAN ON-LINE, DISCOUNT STOCKBROKER[1]

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Abstract

This case explores the challenges of launching a new on-line business within an existing business, its unique IT needs, and how these needs change as the business matures. The case describes how Commonwealth Securities Limited (CommSec), a wholly owned subsidiary of the Commonwealth Bank of Australia ('the Bank'), successfully established itself as the leading discount stockbroker in Australia. It has been able to use its autonomy to get a small company feel within a large organisation. Its success involves a clear business strategy, customer value proposition and an aggressive pricing strategy. This was underpinned by 'low cost' technology, which has been used to maintain its price leadership position.

Keywords: New ventures, competitive strategy, business and IT alignment, disruptive innovation, teaching case

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[1] This case was prepared by the authors with the support of the Commonwealth Bank of Australia. It is intended for teaching purposes rather than to illustrate effective or ineffective handling of an administrative situation.

Introduction

Commonwealth Securities Limited (CommSec) was formed in mid-1995. Its value proposition was 'to provide easy, low-cost access to the Australian Stockmarket for everyone'. By 2002, CommSec had grown to be the largest discount stockbroker in Australia with over 500,000 customer accounts, a staff of 320 people, and an average of 10,000 daily trades, which represented 9% of all Australian Stock Exchange (ASX) daily trades.

Profitable since its second year of operation (see Exhibit 1), CommSec has maintained its leadership position through periods of tough competition, reduced retail transactions, and economic uncertainty in major global markets. It has been able to leverage its low-cost position and market leadership to be a price leader. At the same time, it has extended its services to include margin lending, superannuation and managed funds.

Competitive Strategy

The strategy for CommSec was developed in 1994 in support of the Bank's vision to expand into a broader range of financial services. Mike Katz, the new head of the Bank's Institutional Banking (IB) division, recognised that an equities group was needed to extend the Bank's traditional lending relationships with major companies and to meet their full range of funding needs. As Paul Rickard, Chief Operating Officer of CommSec (See Exhibit 2), explains:

> *When companies want to fund projects, sometimes they consider capital, sometimes they consider loans and sometimes they consider a combination of the two. If you are an Investment Bank and you can only help in terms of the lending side, then you miss a lot of the opportunities. So strategically, we needed to have a strong presence in the equity formation side. Paul Rickard, Chief Operating Officer*

To sell new securities issued by its major corporate clients, the Bank needed a distribution capability, which was traditionally provided by stockbrokers and investment banks. The option of acquiring or forming a joint venture with an established broker was rapidly discarded. Several such ventures had failed around that time, including the Bank's own relationship with Burdett Buckeridge Young Limited (BBY) acquired through its merger with the State Bank of Victoria in 1991, which was subsequently divested. Ultimately, such relationships had failed due to the different cultures of banks and stockbrokers, and the latter's commission-based remuneration system.

An alternative model was developed, which required building a stockbroking capability based on the Bank's established distribution capability. This approach leveraged the Bank's traditional strengths and customer base while avoiding the pitfalls associated with the established market participants. Rickard recalls:

> *We did a lot of research and discovered that the perception of the stockbroker was very much somebody who wears a double breasted suit, drives a red Lamborghini and has a big fat cigar. For most people, that's a pretty intimidating image and consequently the stockbroking market was servicing basically the same sort of client. It was only servicing those clients who had a lot of money and there were 90 firms essentially doing the same. Paul Rickard, Chief Operating Officer*

The market research identified three established market segments: shareowners/ traders, professionals and executives, retired and other non-working people, and a large group of under-served younger and/or newer shareholders with undiversified and low value share portfolios with relatively few transactions (Figure 1). As traditional brokers had not focused on this latter group, many shareowners had no existing relationship with a stockbroker.

The potential of the young and newer shareowners was expected to grow significantly through continuing privatisation of government assets, demutualisations and other share offerings. This included the Bank's own privatisation, Telstra and TAB. Whilst the 1991 ASX survey of shareownership in Australia reported 10.2% of the adult population were direct shareholders (up from 8% in 1988), that was still less than half of the comparable figure in the United States or Britain. Mal Stott, Head of Products, was able to leverage his experiences from the UK:

> *[comparing the situation to the UK] there was growing evidence in the UK about the disconnect between the broad-based first time shareholders and the stockbrokers in London. For many of them, their only experience was to buy shares on the floats and then to sell them. This had little connection with understanding the benefits of longer term direct investing in shares. Nor was there a broad-based and respected stockbroking service where the new shareholders could get easy, low cost access to the*

> *market. We recognised the early signs of similar issues facing growing numbers of Australian shareholders in 1994. We believed then the U.K. brokers missed an opportunity, and that the same opportunity existed here. It was our view that we had the capacity and brand to introduce technologies and processes to take stockbroking services to all Australians interested in shares. It sounded like something that the Commonwealth Bank ought to be doing. Mal Stott, Head of Products*

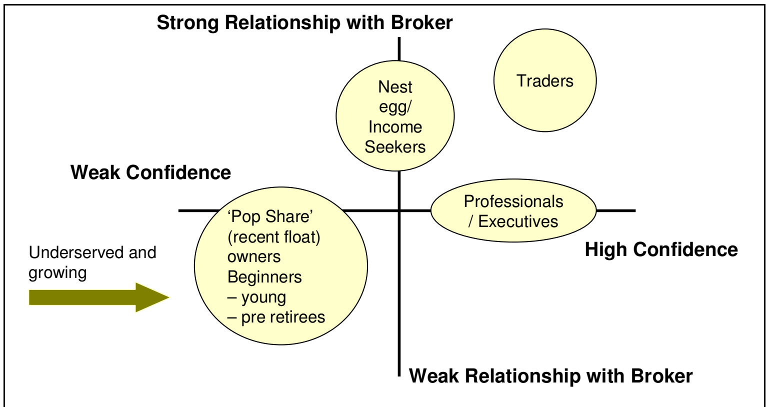

Figure 1. Market Research - Customer Segmentation

In targeting this sector, a competitive strategy was identified in which 1) the transaction cost was unbundled from the costs of research and advice, so that customers could pay only a transaction fee, 2) Sales staff were not to be paid on a commission basis, and 3) the strategy utilised new technology made available by the ASX, for electronic settlement and registration.

The business case was presented to the Bank's board in November 1994 and approved. For the Bank, it was a relatively small upfront investment of under $5m. It contained a staged approach for both primary (new issues) and secondary (ongoing listed products) markets. By starting in the secondary markets with a stockbroker on an agency commission basis, this would be built upon to enter the primary markets and achieve the longer-term goal of having a balanced presence in both areas:

> *In Australia, with privatisations and introduction of banking credits, the recent surge in private shareownership associated with privatisation and franking credits, and the new dealing, settlement and communications systems that are being introduced by the ASX, provide a unique opportunity to establish an internally developed secondary market discount stockbroking business. Operating on an agency brokerage basis, it is intended to create a profitable equities distribution capacity. This capacity will enhance our limited primary market ambitions. Business case, November 1994*

Startup

Commonwealth Securities Limited was founded as a wholly owned, but not guaranteed, subsidiary of the Bank. This was required for regulatory reasons, avoiding the need for the ASX to regulate the Bank's total operations. Mike Katz was appointed Chair of the Subsidiary Board, along with two directors, Paul Rickard and Mal Stott. Both directors were required to be members of the ASX. Despite not previously working in the equities market, they met the significant challenge of learning the ASX business rules and laws and passing the required examinations for their membership.

CommSec's initial value proposition – providing 'easy, low cost access to the stockmarket for all Australians', was simplified to three key elements: 'easy, accessible and affordable'. First, the service was to be 'easy', in that it was to be jargon-free, where possible, approachable even for smaller trades, and have the backing of a big 'friendly' brand. Prohibited by the ASX from using the Commonwealth Bank logo, CommSec selected a disused logo from Bank archives with similar features. Second, the service was to be 'accessible' using national access telephone services, extended hours and the rapid adoption of technology. Finally, the service was to be 'affordable' through the competitive strategy of unbundling research and advice from the actual trade and removal of the commission-based remuneration system.

CommSec launched its 'Share Direct' service on 31 July 1995, as a telephone-based stockbroking service with a minimum fee of $75 per trade. The service was located in Sydney and available nationally for the cost of a local telephone call. The new head of Operations, Leigh Conder, recalls starting from a zero base of customers:

> *It was day one. We had no client base. We opened with about 25 staff in total, which included a couple in marketing, about a dozen in the call centre, about half a dozen in the back office, and our two management directors. On day one, I think we did four transactions. Leigh Conder, Operations Manager*

Initially, orders were taken via telephone by a team of Customer Service Officers (CSOs) and passed to an operator for input to the ASX's automated trading system (SEATS).

CommSec initially 'experimented' on Bank staff:

> *We decided to experiment as much as possible with Commonwealth Bank staff and invite them to open accounts and trade through us before we went out to the public and offered a service that we may, or may not, have been able to fully deliver at the time. But that was surpassed in no time, as confidence levels built in a very short space of time. Leigh Conder, Operations Manager*

Many of the existing policies and services of the Bank were set up for a different style of business with different risk profiles and customer expectations. While CommSec was officially part of the Institutional Banking division, which focused on a small number of corporate clients with large transaction values, CommSec managed a large number of retail clients and transactions with relatively low value. Consequently, CommSec had to negotiate changes to the Bank's policies.

> *I remember working with the Bank Group Credit people on what we were allowed to do. The Bank's policy was not to give credit on equities. They wanted us to get cleared funds up front before taking a trade. Cleared funds meant getting money from the client and waiting five days for their cheque to clear. If we'd run with that, we would have been out of business on day one. Anyway, within a few weeks of arguing, we had a workable Credit Policy which allowed people to buy about $5,000 worth of the top 100 or so securities without paying prior to the purchase. If they wanted to buy something else outside of those top securities, then they had to put money up front, but we didn't have to wait for it to clear. Leigh Conder, Operations Manager*

Where they could, CommSec avoided the central functions of the Bank, keeping most of its operations separate, yet leveraging the Bank's strengths where possible:

> *[We had our own] payroll system, HR, premises, technology, marketing…What we basically tried to do was just leverage where we could actually utilise the Bank. So, access to the Bank's customer base, access to the Bank's shareholders, and access to some of their buying power in certain areas were key parts, but everything else was done independently and remotely from their organisation. Paul Rickard, Chief Operating Officer*

For example, in February 1996, 35,000 Bank shareholders were targeted via direct mail to 'attract new Share Direct registrations and to generate business from a group of prospects who are known shareholders and are predisposed to the CBA brand'[2].

All junior staff were recruited from outside the Bank on CommSec contracts, which had more flexibility that the Bank contracts. This approach enabled the building of a new culture and more flexible work conditions, creating a small 'start-up' company feel.

> *The staff we hired had to be trained as barefoot brokers. We set up a training system which allowed us to bring in young graduates and to train them within four weeks on everything you needed to know to execute an equities trade and to do so without giving any advice. Mike Katz, Head of Institutional Banking*

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[2] Source: Commonwealth Securities Limited, Report to Directors, February 1996

CBA management also lent a hand:

> *(The CEO) David Murray was very supportive. He actually helped us launch this thing. His physical presence was important because it attracted a lot of press. He was very positive. We had an amazing press run when we first got started. We had our photographs in the paper - but the only reason for that was that David would come to our press launch and make a speech. We had radio, we had TV – we were dead lucky. Mal Stott, Head of Products*

When launched, CommSec was not regarded as a significant competitive threat by established brokers. However, by their first anniversary, CommSec exceeded the number of trades by close rivals Pont and Rivkin. Growth was further stimulated in August 1996 with a price drop for the minimum brokerage from $75 to $50 per trade. By June 1997, CommSec had received 20,000 responses from its direct mail inserts accompanying CBA Bank statements[3].

> *We were out there trading and the whole of the market thought: 'Who are these people, the Commonwealth Bank trading?' We were definitely treated with contempt by the market as a newcomer. Leigh Conder, Operations Manager*

Going On-line

The CommSec Internet service began in October 1996. There was a growing recognition of the Internet trading trends in the USA, particularly Charles Schwab. The Internet had some attractive conceptual benefits. As CommSec had grown, natural fluctuations in transaction volumes made it difficult to forecast appropriate call centre staffing levels and the time span to hire and train new operators was three months.

The site started as a non-interactive informational site providing static details of CommSec and contact details. The original web site was designed and hosted by Lintas, the Bank's advertising agency at that time, on a server shared with three other companies. While Lintas went through significant organisational learning to develop the site, it struggled to form a sustainable business. Within six months, it had exited the on-line / e-Commerce business.

> *The application caused Netbank to fall over and people couldn't get access their Internet Banking. We got an ultimatum that they were going to shut us down, roll the whole thing up, and close it off. We went in for a gunfight and just spontaneously said: 'Well why don't we just get our own box and we'll put our own machine in'. They'd say: 'Oh you can't do that …It's all too hard' We'd say: 'We can do that. We can do anything.' So we did. Rob Morgan, IT manager*

CommSec took the hosting and ongoing development of the web site in-house. Rob Morgan and Keith Howie, who were originally IT contractors, created a small IT company, CommSolve, which went on to become a key technology partner with CommSec.

The site rapidly moved to providing live pricing for selected stocks and, by March 1997, it accepted customer orders on the top 300 stocks. Initially, the minimum trade price was set at the same rate as the call centre, at $50 per trade. The system was still predominantly manual, with a printed 'deal ticket' produced for each order, which was then entered into both the front-end and back-end systems.

> *We wanted to do the technology very quickly. What we didn't expect was for it to be as successful as it was - and we didn't consciously bulletproof it up front. We only discovered our points of weakness when it fell over and then we realised what we had to do. I mean, everything was written really quickly…probably in a reasonably unstructured way, as you tend to do, and without a lot of control. So things would fall over and you would have to work out what you're going to do. Paul Rickard, Chief Operating Officer*

Partly to reduce costs, CommSec managed the development and growth of the Internet business itself, buying in external resources where required. To respond quickly to the market, they started developments on a small scale, managing the risk and then building on top of them. Where appropriate, they also developed partnership deals, for example, with information and research providers, avoiding having to develop all of the technology themselves. These deals were done on a fixed fee basis rather than a per transaction basis, which protected the business from exploding costs as the number of trades grew.

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[3] Source: Commonwealth Securities Limited, Chief Operating Officer's Report, August 1997

During its early years, CommSec remained relatively autonomous. It avoided much direct involvement from the Bank, which was then primarily focused on other major investment activities, such as the Bank's entry into the general insurance market.

> *We were cautious because we knew that we were way out on a very thin limb. I didn't actually know this at the time but we would have been chopped off at the drop of hat. We were an experiment and, had it not worked, then the Bank would have walked away from it. Leigh Conder, Operations Manager*

Driving and Managing Growth

By mid-1997, it was clear that CommSec had proved itself as a business. Mike Katz brought in John Beggs as the Head of Equities, which included CommSec, to grow the business and expand the product range.

> *On his second interview, I showed John the Commsec trading floor, which had about 30 people on it at this stage. John jumped over and spent the next 40 minutes looking at a trial Internet platform that we were playing with. He was hooked and signed up pretty much straight away. Mike Katz, Head of Institutional Banking*

Beggs recognised the *'strong potential to combine the muscle of a big organisation with the fledgling technology and the brand of the Bank to develop a strong business'*. He also recognised the need to keep the value proposition clearly centred on cost and service.

> *The CommSec system had a lower cost relative to what anyone else paid. Once we quickly put in place a workable, low cost, technology solution, we were able to lower the brokerage fee for our customers. They were critical decisions. If we hadn't been able to get the technology cost down, we wouldn't have been able to lower the brokerage fee, build our volumes and stay in the rat race. John Beggs, Head of Equities*

The take-up of Internet trading was rapid, fuelled by the favourable economic conditions of the time, a growing number of shareowners, many successful privatisations and demutualisations, generally positive equity returns, low interest rates and growing market awareness.

To grow the Internet business, two critical decisions were made: to provide free share quotes and 'go aggressively on price'. At the time, CommSec was the only service in Australia to provide free live share quotes. The attraction to customers was the level of information it provided and the ability to check current share prices. From CommSec's perspective, the call centre workload could be substantially reduced, as 30% of calls were solely for share prices.

The decision to 'go aggressively on price' was taken in April 1998, prompted in large part by the impending entry of the US-based E*Trade into the market. E*Trade announced it would offer a price of $49.50 per trade. This was a relatively high cost structure compared to its parent operations in the US, due, in part, to their local structure which required high fees to be paid back to the parent company. Two weeks before E*Trade was launched, CommSec dropped the price for the Internet service to a minimum of $29 per trade, while maintaining its call centre minimum price at $50. This drop in price triggered rapid growth.

> *From there, the thing just took off. We expected a little bit of price elasticity but we had no idea it was going to be as elastic as it was. Paul Rickard, Chief Operating Officer*

The number of trades leapt from 2,476 in April 1998 to 28,776 in December of that year. At the same time, CommSec's market share of the number of trades surged from 3.07% to 6.87%[4]. From April 1998 to early 2000, the number of staff grew to meet the massive demand. Telephone brokerage grew from 20,000 trades a month to around 70,000 a month by March 2000. During this period, Internet trades were doubling every three months, and moved from 20% of all trades to 80% of all trades.

CommSec was unable to respond quickly enough to this growth. There was great pressure to migrate customers from using the telephone to using the Internet. It took three months to recruit and train a call centre operator. At the

[4] Source: Commonwealth Securities Limited, Report to Directors, Attachment A, October 1999

peak of growth, 60 operators were recruited in a single month. CommSec was borrowing premises and overflowing into the Bank's main call centre. As Michael Blomfield, the Senior Manager, Client Services[5], explains:

> *We were just so busy in the last couple of months of '99 and the first couple of months in 2000, we just couldn't cope. We had huge call queues. We were getting so many letters reflecting dissatisfaction back on the Bank. So not only did we have to deal with the customers, but then you had to deal with customers complaining to Branch Managers, and even customers writing to David Murray (the CEO). Michael Blomfield, Client Services*

During this period of rapid growth, customer demand consistently outstripped CommSec's ability to supply. The main measure of client service, the number of calls answered within 20 seconds, dropped to zero.

> *We managed to turn complaint resolution management into one of our greatest strengths, I think. We actually are really good at that. Our business is a great example of how much value a complaint can add to your business and how much good management of the complaint can add to your relationship with a client. Michael Blomfield, Client Services*

There was a constant battle with capacity. CommSec purchased their own servers and moved them to a dedicated web-hosting facility, with applications servers within the CommSec premises. System outages cost CommSec dearly, not only because of the lost time, but also because they had to honour trades that had not been completed on time at prevailing prices rather than executed prices. However:

> *You'd do an upgrade and get more capacity and you could breathe easy for three months which you knew was only temporary because the customer base was growing so quickly. Rob Morgan, IT Manager*

To address its technology performance issues, CommSec undertook an extensive evaluation and upgrade of the web systems. It moved to a 'hot-hot' architecture which required duplicating the web servers in an alternative hosting site and having dynamic load balancing across the two sites.

> *I think we knew more about the Internet than anyone else in the organisation, and we probably knew more about it than most people in Australia. We couldn't turn to anybody. So, when we were looking at, for example, dynamic hosting, there was no one who'd done that in Australia before. We split the host to two sites and tried to run them in parallel. No one had done that before. You would go and talk to the Microsoft people and all they could do is find you someone in the US. There was no local expertise. Paul Rickard, Chief Operating Officer*

With the growing market acceptance of Share Direct, customers were increasingly demanding new features and tools on the Internet site. Driven by strong competition, new services were introduced to provide market depth information, dynamic charting, watch lists, real-time updates and company profiles.

> *Somebody told us that E*trade has got graphs, so we said: 'How quickly can we get graphs?' John came back from a project meeting and said to me: 'Can you get graphs live in three weeks?' And I said: 'Oh … probably!' John said: 'That's good, because I've just promised that we will.' And we did. We had daily price history graphs up there in three weeks. Rob Morgan, IT Manager*

New features were delivered incrementally, with regular feedback from clients:

> *One of the things that we've done well over time is that we have tried very hard to be continually releasing stuff to the Internet site. We don't break projects down into three-month deliverables and deliver six bits of functionality every three months. We try and run lots of projects and that's to give our clients a sense that we are moving forward. So, from time to time, we will hold back functionality and release it a couple of weeks later rather than releasing two or three bits of functionality at once. That tells your clients that you're still working, you're still thinking, you're still trying to add value which I think is a really important tenet of an Internet business, to be continually upgrading. Michael Blomfield, Client Services*

To continually and rapidly release new functionality to the market place, CommSec eventually had to deal with the constraints of their aging settlement clearing system, Broker. The system was originally built by ANZ Bank, who

[5]This role included responsibility for the Call centre and Internet teams.

then sold it to Fujitsu, who sold it to ACT, which was then taken over by Mysis. There were problems with stability, and the application also lacked flexibility to access data tables, making it difficult to extract customer information and add on other developments.

Rather than initiating a large systems replacement project that would have incurred significant cost and a massive disruption of business processes, applications and technology, Beggs took a staged incremental approach. This unbundled the changing of the platform from the changing of business functionality and business processes. It minimised the potential impact on customers, reduced the complexity of the system replacement, and provided a robust and scalable platform to build on.

> *As soon as you start talking to any developers about upgrading the system and talk to any of the business people about it, they start telling you all the things you could have, and all the things you need to have, but you don't have now. However, complexity grows exponentially as a function of the number of changes, driven by the effort for specification, coding, and user acceptance testing, as does the potential for unintended consequences to the production environment. John Beggs, Head of Equities*

CommSec co-funded the redevelopment of the settlement clearing system with the vendor, Mysis. Initially, it was redeveloped with the same functionality, but also with well defined interfaces to allow building and integrating new functionality. This approach unbundled the changing of the platform with the changing of business functionality and business processes. This minimised the potential impact on customers, reduced the complexity of the system replacement and provided a robust and scaleable platform to build on.

Given that up to 30 other stockbrokers also use this system, this also benefited Mysis: Blomfield recalls:

> *It was a long, long negotiation it took six months to negotiate that deal with the vendor because they wanted us to pay for it. At the end of the day, I don't think they had 50% of the risk, but they had sufficient in it that they absolutely had to get it right.*

Within six months, one of the largest broking applications in the country was rebuilt.

> *We didn't have that as an exclusive arrangement with us because we recognise that they (Mysis) have to stay in business. This is about leaving something on the plate for your vendor. We've helped them modify their system so they've got a better offering to remain commercial and competitive in the market because if they went out of business, then that would cause us an incredible amount of grief. Leigh Conder, Operations Manager*

This technology development occurred while the Bank entered into a ten-year single source joint equity outsourcing relationship with EDS, in October 1997. Although the new deal had provisions for all aspects of technology support and development, it was predominantly oriented around traditional banking services and technology. Despite pressure from the Bank, CommSec limited its relationship with EDS to the support of administrative and major back-office production servers.

> *One absolutely critical decision I made was not to use the Bank's outsourced IT provider because their prices around basic technology were huge. Also, they wanted to take the technology and leave us without any ability to pre-test and test it. It was critical that we didn't outsource the business intuition. John Beggs, Head of Equities*

The last major system upgrade was the implementation of Straight Through Processing (STP) in December 2000. There was pressure in the market to execute orders immediately. CommSec initially resisted the pressure because orders were already executed within seconds. STP took orders from the Broker system straight into the SEATS 'order book', subject to passing vetting rules, without any operator intervention. Once the order was executed, it was then automatically matched with the client's order, booked to the client's trading account, and a contract note printed and mailed out, with an email confirmation, if requested. This placed CommSec was at the forefront of delivering large-scale transaction systems.

A unique feature of the STP was that it was designed for maximum business flexibility.

> *We figured the whole thing had to be very flexible because CommSec changed their processing rules on a daily basis, as things happened in the market. So we realised that we had to be able to externalise the business rules so that, if you've got to change the vetting or redirect market orders to a manual*

workbench, then the guys could go in and change one line of code, check it, load it, and send it live. Turnaround time ten minutes. Rob Morgan, IT Manager

A key feature of STP was that the business rules (for example, determining which trades should be manually vetted) were not hard-coded into the system. Instead, they were implemented by modifying configuration scripts accessed by the system. The system had a sophisticated architecture based on middleware messaging and distributed objects that enabled changes to be implemented by modifying configuration scripts rather than modifying the system. This enabled development to proceed quickly and provided maximum business flexibility when in operation.

To achieve the agility required by CommSec, Morgan described the many system changes designed to keep pace with the changing business, requiring a trade-off between risk and agility. To maximise agility while minimising risk, he espoused a 'dynamic mode of operations', which rapidly responds to problems as they arise, rather than avoiding them altogether. This often needed access to the developers, who had tacit knowledge of the functionality of the system, alongside the operations team. This was the case in the CommSec environment, where systems were developed with extensive use of configuration scripts, allowing tuning and configuration in the production environment. This is in contrast to a mature mode of operation, where risk is offset by the reliability of testing, very mature processes, strong release control and separation of production and development.

What made it work? One word, Agility! Rob Morgan, IT Manager

The STP system enabled scalable processing, which enabled CommSec to rapidly execute more than 100 trades per second.

The market really went through a phase of STP being the all-important thing - until we got STP. Then, nobody saw this as being important anymore! Leigh Conder, Operations Manager

Competition

In response to CommSec's success, competition grew rapidly both from established players such as Sanford Securities and E*Trade, and from several new players in 1999 and 2000. These included Quicken, HSBC (Internet), St George (Quick Trade) and ANZ (later forming a joint venture with E*Trade).

At the same time, the remaining two major domestic banks, Westpac and National Australia Bank, were preparing to launch in February 2000. As a result, the decision was made to cut the minimum Internet brokerage rate to $19.90 per trade, and to announce this as close as possible to the launch of Westpac's brokerage business.

Westpac cut the same day we announced our cut to $19.90 - and cut to $15. The Bank's Board was meeting, so I rang Katz, the Board discussed it, and they decided to match Westpac. So an hour later, we did a press release to say we'd go to $15 with Westpac. It was a sufficiently hot topic that that decision had been made at the Board. John Beggs, Head of Equities

The strategic importance of this pricing behaviour was driven by the threat to the Bank's core business. There was a concern that new entrants to the on-line stockbroking business could use new electronic, stockbroking relationships with the Bank's customers to offer broader banking services, without the cost bases of established players such as the Bank.

It looked at one stage as if people like TD Waterhouse, Schwab and then the insurance companies might be able to use this [on-line broking] as a vehicle to home in on the Bank's core business … get electronic relationships with clients and take core banking business (retail deposits) away. The Bank recognised the need to maintain the direct relationship with our clients. John Beggs, Head of Equities

The response split CommSec's competitors into two groups. Those positioning themselves to compete primarily on service, such as Sanford and E*Trade, maintained their prices. Others, competing primarily on price, such as Quicken and Westpac, entered an on-line broking fee war.

By the time the largest potential international competitor, Charles Schwab, had arrived in the Australian market in December 2000, Beggs explains:

They (Charles Schwab) were too late to handle the business and be profitable. The very low margins, combined with a costly joint venture structure with Packer, and the high costs of interfacing *international systems to ASX systems, saw Charles Schwab exit the market in January 2002. John Beggs, Head of Equities*

The relative market shares over time are shown by number of trades and value in Exhibit 3, with CommSec consistently the market leader. CommSec recognised that part maintaining market leadership was understanding how the market leader should behave with regard to pricing, functionality and behaviour. This positioning also allowed it to consider when to undertake major changes, specifically, whether it would lead the market or be a follower, waiting until the change was more prevalent or a lower risk. CommSec also reinforced its leadership position by ensuring it had a strong voice in the broking market through TV media deals with Channel Ten and Sky News.

Diversification

Over its first three years of operation, CommSec expanded its range of products to include bank bills, options and warrants, and international shares. It also built a small advisory service to offer share-trading advice and had made some progress on its primary markets ambitions with several underwriting and distribution activities.

Along the way, CommSec also tried other products, which were not successful. For example, Aussie Shares was a non-advisory but pre-packaged parcel of Australian shares, starting at $3000. Despite positive market research, extensive advertising and training of branch staff, sales were insufficient to cover the marketing expense. Other Internet products were attempted but were not successful. This included a foray into motor vehicle insurance brokerage. As Rickard reflects:

It took us a while to realise that complex products are not purchased on-line without a lot of work.

CommSec diversified into the Commonwealth Direct Investment Account (CDIA), margin lending and funds Nevertheless, the spectacular growth and perceived prospects for on-line brokers at the height of the dot.com boom promised unbounded opportunities. In April 1999, JB Were & Son valued CommSec's on-line business at $1.01bn or $1.11 a CBA share, driven by strong investor demand for on-line brokerage and a sharp rise in shares of other on-line brokers in the market [6].

Despite this external optimism, CommSec was more cautious. As its revenues were mostly transaction and volume based, they were highly susceptible to changes in the market. At the instigation of Beggs, CommSec engaged the services of Professor Woodland from the University of Sydney to assist them in looking for ways to 'crash proof' the business in the event of a 1970s style bear market. What would it mean for CommSec and how would they survive?

Now, he never answered that question. His answer was a very long and complicated formula, which effectively said that the share market is stochastic. But in the process of getting to that conclusion, which was entirely true, we managed to understand that we needed to have counter cyclical revenue and we needed to have transaction insensitive type revenues. That's why we have a margin lending business and it's why we have a managed funds business. Michael Blomfield, Client Services

The Commonwealth Direct Investment Account (CDIA), margin lending and funds management products were launched. The margin lending business was supplemented in 2001 after the Bank's $9bn acquisition of Colonial Limited, which incorporated the Colonial margin-lending product offered through intermediaries. By mid-2002, the CDIA balance was over $1bn, the combined margin lending book value was over $2.6bn and Funds Under Management were over $778m.

The establishment of the margin-lending product and, to a lesser degree, the Funds Under Management business, were fundamental to protecting CommSec's financial position following the global meltdown of dot.com and technology stocks. With a 30% drop in transactional volumes during the 2000/01 Financial Year, net earnings were impacted less than 5.6%, with CommSec declaring a profit of $13.81m and providing a $12m dividend to the Bank.

*CommSec remains the only profitable on-line broker in the domestic market, with rivals such as E*Trade Australia and Sanford Securities continuing to rack up losses. E*Trade, Australia's second*

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[6] "CBA's Broker could become a $1bn Bonus", Sydney Morning Herald, 13 April 1999

largest on-line broker, posted a $33.3m net loss for the 12 months to end of June 2000, while Perth-based Sanford burnt $54.6m.[7]

Consolidation within CommSec (Maturation)

CommSec grew to a peak of 380 staff in 2000, later reducing to approximately 300 as the market eased. Given its nature as a call centre business, with an annual turnover of approximately 30% of junior staff, in all nearly 600 people had been recruited by 2002. In general, the members of staff were excited to work in CommSec. The nature of its business and reputation in the market was well regarded. This added to the positive culture of CommSec:

The young kids who worked there were pretty excited for the most part. It's worth a lot to them among their peer groups to say they work in CommSec. John Beggs, Head of Equities

Every person who works here has had a very, very personal buy-in to the organisation and its goals and we literally believe in our business and love our clients and want to do well for them. Michael Blomfield, Client Services

The culture evolved quickly into an exceptionally good service culture. I think we've well and truly got the service right, whether that's Internet or whether it's over the phone. Our culture has been what the market was looking for. It's what traditional brokers could never even conceive. Leigh Conder, Operations Manager

In the initial phase, the senior management team of CommSec was only six people. The structure was relatively flat and by some counts, lacked the structure and process required for what was now a medium size business.

There weren't many operations procedures and processes early on. Getting those plans in place for how we were going to deal with things, to a degree, has been a very dynamic situation. You sort of fly by the seat of your pants a little bit. You're using systems that you have no experience in, you've got this collection of staff that have never worked together, you're using telephone systems that have never been used by that group of people before. Leigh Conder, Operations Manager

There was a large gap between senior management and staff. It was not until 2000 that an additional level of management was created, when John Beggs insisted that all senior managers have a second in charge.

It was in about 2000 that John Beggs went through the business and saw there was no support. There were senior executives and staff and there was this massive chasm. It was a little unstructured and I think the business lacked discipline. Every time something went wrong, the whole place just ran around screaming 'I'm a teapot'. It was just hilarious to watch. So John came in and said: 'Everyone needs a second-in-charge'. We needed to build another layer of management in the organisation. Michael Blomfield, Client Services

At the same time as the business maturing, so did the IT practices. Extensive testing was now standard practice for the delivery of any new system.

We spent hours and hours with some of our lead developers working through the capability maturity model (CMM) to the way people worked and the way the whole team worked as an engine. Really, what we were striving to do was to get strong processes, to get a strong, robust delivery, and an enterprise mission critical type recognition process, but enabling agility. Rob Morgan, IT Manager

By the end of 2002, the Internet systems had been stabilised and CommSec was serving 140-150 million hits on its web site per month. It was regularly the number one hit site in Australia and it had developed into an industrial strength Internet operation. CommSec had consolidated itself as the leading discount stockbroker in Australia, performing 9% of all trades on the ASX each month, representing approximately $1.4bn per month by value.

It was a hell of a good time. It was a fantastic experience to grow from nothing to the biggest broker in the Australian market. We probably attained that in about our third year so it was quite incredible. You really got stretched and you stretched the staff, but it was rewarding because you were always making new milestones. Leigh Conder, Operations Manager

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[7] 'CommSec Profits Trimmed 5.6pc', Australian Financial Review, 5 December 2001

Integration with the Bank

In December 2001, CommSec was moved into the Bank's newly created Premium Financial Services Division (PFS). The new PFS division brought together existing wealth management businesses from different parts of the Bank to enable it to better focus on high net worth customers with more complex needs. Mike Katz was appointed Group Executive to head PFS.

The inclusion of CommSec brought a direct distribution capability, a retail client base and the ability to leverage the technology platform. Mike Katz looked to continue CommSec's success, but also leverage its capabilities as an integral part of the PFS business and technology delivery. Several strategic opportunities were available:

- extending CommSec's stockbroking capabilities to increase its share of the retail market;
- building on CommSec's stockbroking capabilities to realise its primary markets ambitions as an institutional player, as outlined in its original business plan;
- leveraging CommSec's resources (customers, people, technology) to deliver the broader range of banking and insurance services across PFS; and
- applying the CommSec approach to create a new venture in another part of the financial system, for example, financial planning or insurance.

As the newly appointed Chief Operating Officer and General Manager of CommSec, Michael Blomfield was faced with the challenge of creating better synergies between the CommSec stockbroking business and the wider group, while maintaining focus on this low-margin, highly competitive business. At the same time, he needed to reposition CommSec to reflect the positioning of PFS.

> *The value proposition of 'easy, accessible and affordable' is less clear when operating as part of a premium business. Michael Blomfield, COO and General Manager*

Along with the opportunities, there were concerns that the priorities of other parts of PFS may take the focus of activities from CommSec.

> *CommSec itself doesn't bring in a lot of money. When you compare it to the Bank, it's trivial. We are basically a rounding error in their profit and that's scary because maybe we will fall by the wayside. As the number of people grows from 300 to the targeted 1500, how will the 'dynamic, aggressive, get on with it' culture be maintained? Michael Blomfield, COO and General Manager*

Summary

CommSec is a successful example of a startup on-line business launched as part of an existing business. Its success has been underpinned by a clear business strategy, customer value proposition and a low-cost pricing strategy.

It has been able to use its autonomy to get a small company feel within a large organisation. As part of this, it has developed 'low cost' technology, which has been used to maintain its price leadership position. CommSec has added to these systems incrementally in conjunction with close vendor relationships, while maintaining its 'business intuition' and internal IT capabilities.

CommSec has developed an approach for implementing systems that maximises the agility of an organisation, whilst managing the associated risks. This has been achieved by the tight integration and sharing of knowledge between operations and development in the 'dynamic mode of operations', and, by reducing the complexity of systems developments, focusing changes on the underlying platforms before extending the functionality of the system.

CommSec presented CBA with a number of options going forward to leverage CommSec's successful business model and retail distribution capability to the new areas of PFS, while still maintaining its leadership position in the discount stockbroking market.

Exhibit 1. CommSec Financials

	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02
Income	$3,717	$11,301	$21,870	$41,467	$91,210	$84,845	$85,691
Expenses	$13,867	$10,290	$15,579	$32,104	$65,039	$64,952	$63,332
Net operating profit before tax	-$10,150	$1,011	$6,291	$9,363	$26,171	$19,893	$22,359
Income tax expense (benefit)	-$3,623	$416	$2,345	$3,189	$9,577	$9,077	$4,429
Net operating profit after tax	-$6,527	$595	$3,946	$6,174	$16,594	$10,816	$17,930
Assets	$14,602	$24,023	$67,136	$91,326	$292,318	$160,133	$204,849
Liabilities	$14,201	$18,027	$57,193	$71,208	$255,606	$124,605	$171,390
Net Assets	$401	$5,996	$9,943	$20,118	$36,712	$35,528	$33,459
Shareholders Equity							
Capital	$7,000	$12,000	$12,000	$16,000	$16,000	$16,000	$16,000
Retained Profits (loss)	-$6,599	-$6,004	-$2,057	$4,118	$20,712	$19,528	$17,459

Exhibit 1. CommSec Selected Financials 1995 – 2002 ($'000)[8]

Exhibit 2. CommSec Structure

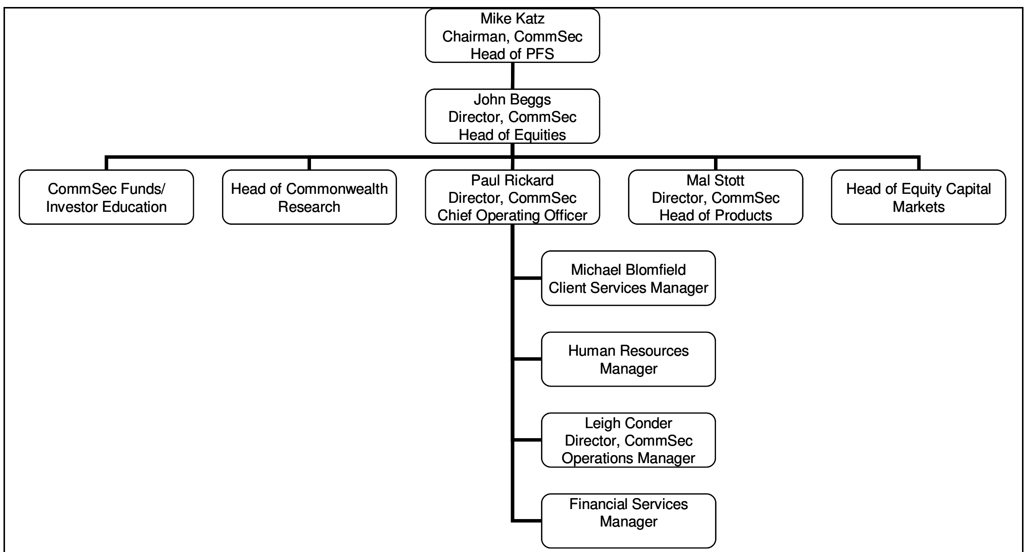
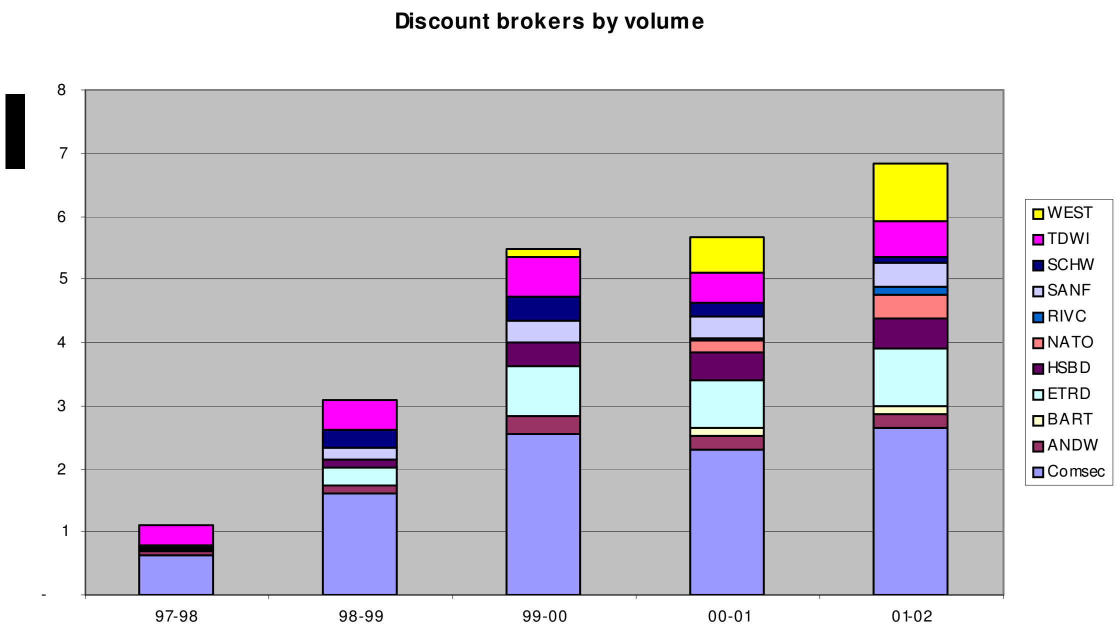
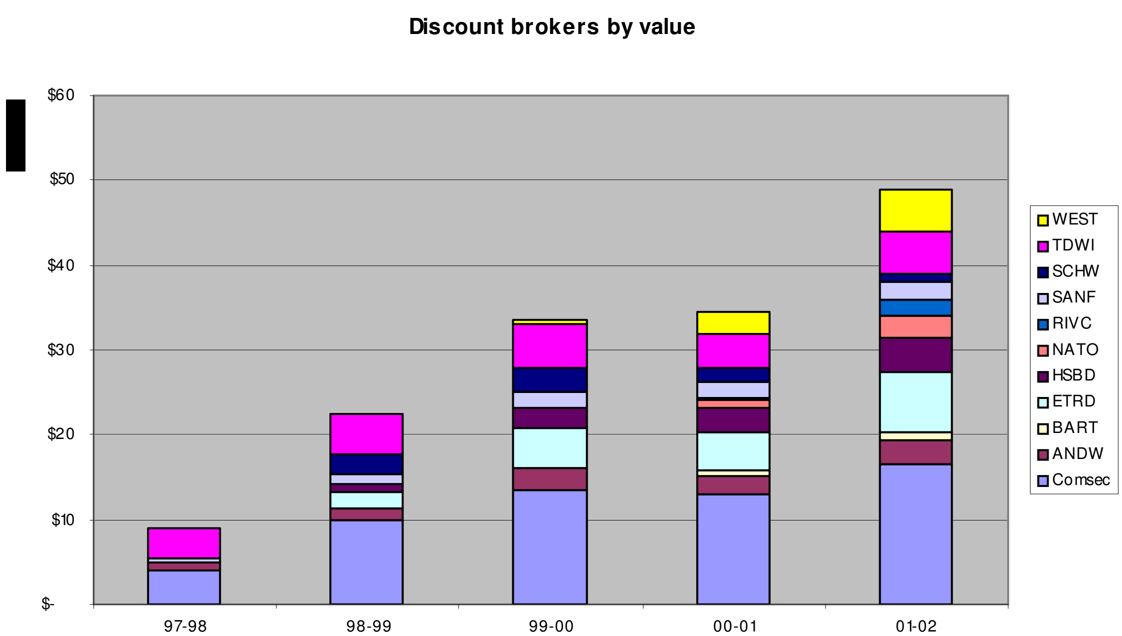


Exhibit 2. Organisational Structure – CommSec Pre PFS Integration[9]

[8] Source: CommSec internal records
[9] Source: CommSec internal records (extracts only, shown from charts not a complete description)

Exhibit 3. Market shares of Discount Brokers





Source: CommSec internal records (in turn, calculated from SEATS data).